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SUBJECT: CZECH REPUBLIC: ECONOMIC REFORM PACKAGE PASSES
FIRST READING BUT FACES UPHILL BATTLE IN PARLIAMENT

REF: PRAGUE 359

11. (SBU) SUMMARY AND COMMENT: The Topolanek government's economic reform package passed its first reading June 8 and now faces the most difficult phase of debate and amendments before it goes to the second reading in August. The economic reform bill is the flagship of the Civic Democrat (ODS) coalition government and contains much of what the party has preached during its eight years in opposition. The reform package is a source of great controversy even within the coalition, as evidenced by high turnout for the first reading. While individual components of the bill (e.g. flat tax, healthcare co-payments) are causing some rift, it is the politics of compromise rather than the economic merits of the bill that poses the greatest challenge to the bill winning final Parliamentary approval. This will be a test of Topolanek's leadership and management skills as he does some soul-searching about the trade-off between meaningful economic reforms that risk failure in Parliament vs. a "better than nothing but not by much" reform bill that will survive Parliamentary approval. The outcome of this bill has the potential to bring down this government since Topolanek has linked it to a Parliamentary vote of confidence on his government. Debate and compromise in the run-up to the second reading in August will reveal more about the likely fate of the Topolanek coalition. END SUMMARY AND COMMENT.

PUBLIC FINANCE REFORM VIA TAX CUTS, SOCIAL WELFARE
RESTRUCTURING, HEALTHCARE REFORM

12. (U) The Topolanek government's controversial economic reform bill -- flat and lower income & corporate tax (with numerous exemptions), higher rate for the lower VAT bracket, cap on social security tax, increase in the retirement age, reduction in some social welfare benefits, restructuring sick pay, introduction of healthcare co-payment (reftel para 7) -- passed the first of three readings in the lower house of Parliament June 8. The first reading is a simple yea/nay vote to consider the bill, and it is during the period before the second reading that most of the haggling over the content of the reform package will take place. The second reading is not expected before August 7, after Parliament returns from its summer recess. ODS' focus is the "misused social state" based on the principal that it should be more advantageous to work than to be on social welfare. The current system, according to ODS, disincentivizes some income groups from

seeking employment. The opposition Social Democrats are strongly opposed to the flat tax, preferring instead a progressive tax system. They also oppose payments for prescription and medical consultations.

13. (U) Economists generally agree that something must be done about public finances and concur that this reform package is better than nothing, even though these can hardly be described as "radical" reforms. Instead of using increased revenues from changes to the VAT rate (currently "basic goods" are charged 5% and "luxury goods" are charged 19% but the new system will raise the lower rate to 9%) to finance the deficit, the Topolanek government will use it to offset the lower income and corporate tax rates. So while the proposed changes to the tax regime sound the most radical on paper, in terms of budgetary impact, the changes are budget-neutral at best. The majority of the impact on public finances will come from changes to the social welfare benefits (sick leave pay, maternity pay, child benefits pay). Economists agree that the primary problem with the budget deficit is on the expenditures side (i.e., social welfare) than on the revenue side (i.e., tax policy).

14. (U) The specific contents of the reform package are significant on their own merits but even more so when considered in their entirety as a drain on public finances that derailed Czech aspirations to join the eurozone in 2009. Despite the robust GDP growth of over 6% for the past two years, the Czech general government budget deficit ballooned from 2% in 2005 to 2.9% (estimated) in 2006. The budget deficit forecast is estimated at 3.9% in 2007 and 3.6% in 2008. The main culprits are the tax cuts and the significant increase in mandatory social spending in the run-up to the June 2006 general elections. The new public finance reform package seeks to reinstate fiscal discipline and push the

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deficit down to 2.6% by 2009, as reflected in the latest update to the Czech-EU convergence program completed in March. On June 13, the European Commission publicly criticized the Czech Republic for failing to do enough to rein in its public deficit. This was widely reported in the local press, but it is not clear whether the Topolanek government will try to use this to garner support for the reform package.

POLITICS OF THE REFORM BILL: LACK OF BUY-IN

15. (SBU) The June 8 vote was very well attended, with 198 of the 200 Members of Parliament (MPs) present, a clear indication of the importance of the issue. Of the two MPs who were absent, one was from the ruling coalition and the other from opposition, thereby balancing each other out in an evenly-split Parliament. 98 MPs supported and 97 MPs opposed the reform package. Three MPs abstained: former Finance Minister under the first un-confirmed Topolanek government Vlastimil Tlustý (ODS), ODS Parliamentary whip Peter Tluchor, and KSCM's Ludvik Hovorka. Had only two of those three opposed, the reform package would have failed. Tlustý, Hovorka, and several other coalition MPs had indicated a willingness to allow the measure past the first reading in order to open up debate on amendments which will precede the second reading.

16. (SBU) This reform package is not just about economic reforms and euro compliance. It is the traditionally business-friendly Civic Democrats' opportunity to implement changes they talked about for eight years in opposition. As a result, when he publicly introduced the bill on April 3, PM Topolanek had said he would link the bill to a Parliamentary vote of confidence on his coalition government. However, he has since backed off from that stance and instead considered "fast tracking" the bill through parliamentary votes to limit debate. However, after about 10 coalition MPs said they

would not support the package unless they were given the chance to discuss amendments, Topolanek dropped the idea. Topolanek will be under significant pressure to compromise on several of the frequently stated ODS goals if he wants to assure passage of the measure.

17. (SBU) One of the most vocal opponents of the reform package from within the coalition is former Finance Minister Vlastimil Tlustý. He prefers a flat income and corporate tax of 12% (vice the proposed 23% for income tax and 19% for corporate tax), simplification of the tax system (fewer exemptions), and VAT rates of 17% and 9% (vice the proposed 19% and 9% VAT suggested by the government). Having said that, our interlocutors believe his opposition to the government plans are more politically motivated than due to ideological differences on the merits of the reform package. Even though he proclaims that the current reform would unevenly burden the middle class, he is more peeved that Topolanek gave up the Finance Ministry, which Tlustý headed under the first Topolanek government that failed to win Parliamentary vote of confidence, to the Christian Democrats. Tlustý wants to win back his lost prestige; that is his motivation.

PROSPECTS FOR SUCCESS: RATHER SLIM

18. (SBU) If the reform package were to fail in the second or third reading, it could lead to the end of the Topolanek government. There has not been a formal decision to de-link the reform bill from a vote of no confidence; Topolanek has simply stopped talking about it and changed his rhetoric to better reflect the political reality -- a lack of buy-in -- even within his own coalition. The coalition government's written manifesto still says it will relinquish power if it can not pass its reform package. With the second reading expected to begin after Parliament returns from its summer recess August 7, and given that the third reading must take place within 48 hours after the second reading, theoretically the bill can pass within the same plenary session in August. The most interesting and significant debate will happen between now and when Parliament reconvenes in August. Post believes the chances for this reform bill winning

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Parliamentary approval in its current form are 51%. However, numerous proposed amendments are anticipated before the second reading and given the unpredictable lusty factor, it is unclear whether and what kind of a reform package will ultimately win Parliamentary approval.
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